Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

May 2015

Last Month in Brief

UK growth slowed in the first quarter of 2015 with GDP increasing by just 0.3%, the lowest rate since 2012, although economists suggest this drop will be temporary, with 2015 still set to yield strong growth. Rises in house prises in the UK, meanwhile, increased to their highest level in 7 months with low unemployment and low mortgage rates likely to underpin strong demand in the months to come according to Nationwide.

The Eurozone exited deflation in April with consumer price inflation up to 0% from -0.1% the previous month. The ECB say that its policy measures of ultra-low rates and quantitative easing seem to be successfully fighting deflationary pressure. Greece, however, continues to be a source of uncertainty as there has been no agreement between Syriza and their EU and IMF creditors.

The US federal reserve again voted to keep interest rates low but indicated that it will raise rates soon as the US continues to grow, albeit slower than expected in the first quarter of 2015.

Russia has cut interest rates following a rally in the rouble as oil prices have strengthened and predictions of high inflation have softened.

Chart 1: Equity Indices

Equity markets saw mixed returns during the month

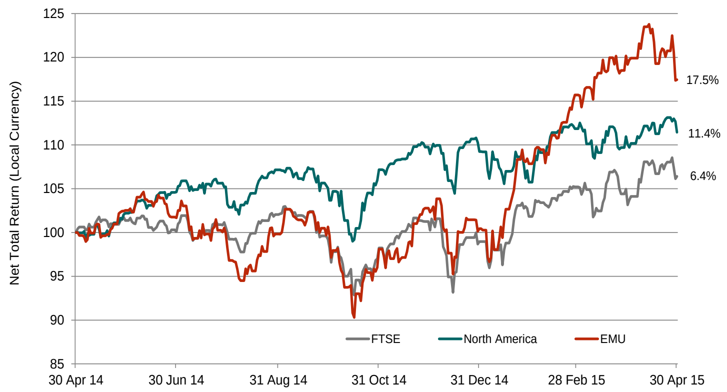


Chart 2: Sterling Credit Spreads

Credit spreads widened slightly during April

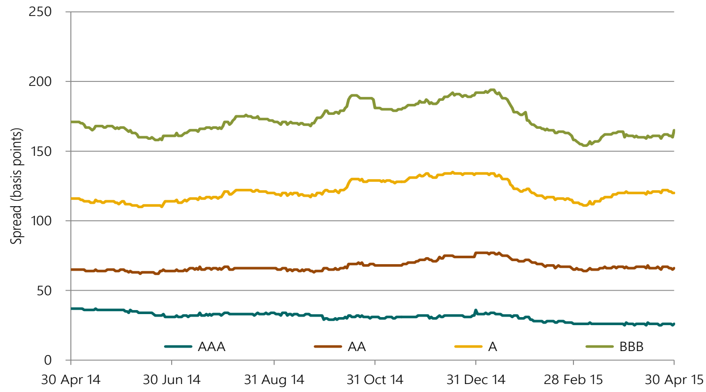


Chart 3: Gilt Yields

Gilt yields have risen slightly this month

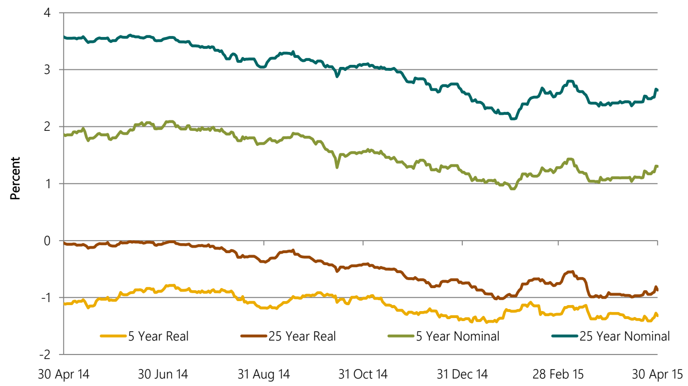
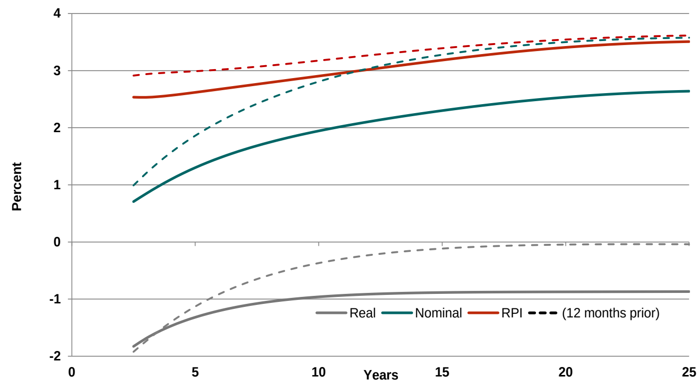


Chart 4: Gilt Spot Curves

The yield curve continues to be low and upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0%	0%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	81.4%	83.6%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	0.4%	-0.3%	**VIX (volatility) index**	14.55	15.29
IPD TR property index (monthly change)	1.3%	0.9%	**$/£ exchange rate**	1.54	1.48

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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DC Freedom & Choice

April 2015 brought in the advent of major pension reforms. In particular the changes allowed members of Defined Contribution (DC) pension schemes greater freedom in the use of their pension fund (see Box 1).

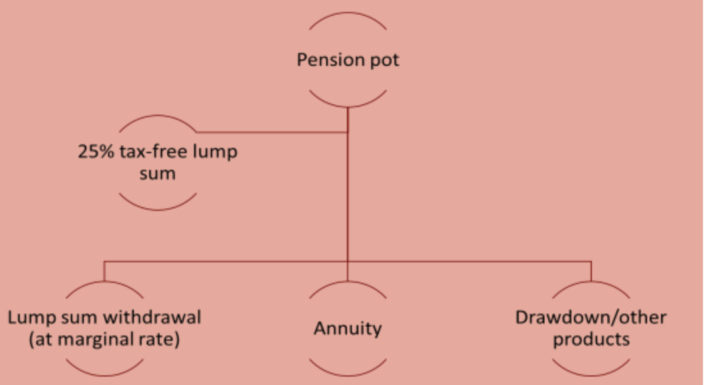
Despite the flexibilities available to members, there's still a great degree of uncertainty on what changes providers will make to their schemes to ensure that they deliver positive outcomes to members. In part this reflects the relatively small number of members who are affected in the short term (only non-retired members over the age of 55 can make use of the flexibilities), however it also reflects the conflicting considerations that providers are grappling with.

Lifestyling

Currently, most DC funds provide a default option which invests in risky, return seeking assets for younger members before gradually transitioning to cash and bonds close to retirement. This 'lifestyling' approach is intended to provide protection for members who buy an annuity at retirement, reducing the risk of selling assets at temporarily low values at retirement.

In future, individual circumstances and preferences are more likely to affect the structure of benefits taken. This makes it difficult to predict the fund structure that will be most suitable for scheme members. The level of 'risky' vs 'safe' assets to hold and when to transition between the two will be substantially different for someone purchasing an annuity at age 67 compared to someone taking the whole fund as cash at age 55 or, indeed, compared to someone who intends to leave the funds invested and draw-down over time.

Box 1: Options for those approaching retirement.



Following an initial option to take 25% of the total pot tax free, pensioners can then choose how to take the rest of their funds based on their personal circumstances and tax position. These options were always available in some form but subject to a minimum/maximum size of pot and potentially liable to significant tax charges.

The importance of the default fund

Whilst providers offer a range of funds to suit personal circumstances (such as age, wealth and risk appetite), around 80-90% of scheme members are currently in the default option, either as an active choice or through apathy. Providers are having to think carefully about how to design a default fund that delivers desirable outcomes for members exercising the different options above.

Some providers are considering a wider range of funds whilst using a reforms-triggered increase in pensions advice to boost engagement around fund choices. This addresses the issue of funds meeting members' needs and provides flexibility to manage changes in circumstances or plans.

Box 2: NEST principles

Following consultation, NEST have outlined six principles to inform the design of default retirement solutions:

>Living longer than expected is the key risk in retirement.

>Savers should expect to spend most or all of their pension pot during retirement.

>Income should be stable and sustainable.

>Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements.

>Providers should look to offer flexibility and portability wherever possible.

>Inflation risk should be managed but not necessarily hedged.

NEST recognise the principles may be in tension with each other and that providers need to prioritise and understand the trade-offs in designing default options.

The role of annuities

Industry experts including NEST and ILCUK argue that common underestimation of life expectancy means that purchasing an annuity with some or all of the value of a pension pot is likely to be the best course of action for a lot of scheme members, especially those with a high proportion of their wealth in DC schemes. They also highlight that the significant fall in annuity rates has coincided with a fall in gilt yields and other investment returns so the relative value of annuities is not as poor as may be perceived.

In contrast to the opinions above, a poll by the SEI showed that scheme sponsors only expect around 25% of their employees to take an annuity at retirement. They highlight the need to offer fund choices and advice which provide flexibility whilst helping members manage their benefits to avoid running out of money in later life.

Pension Providers' Responses

NEST have consulted on the changes they intend to make and have published details of high level themes (see Box 2) that emerged from that consultation ahead of their detailed response later this year.

Some providers have considered profiling members in order to allocate a default for them, although generally there is resistance against this option. Opposers point to practical difficulties to obtaining and processing enough information about members to make appropriate decisions for them.

There still remain a significant number of employers who have not yet taken any action following budget reforms, although the SEI survey suggests that around two thirds of respondents intend to make a change to their default investment strategy over the next 18 months. Whether this involves adjusting the current plan of de-risking over time, offering a choice of default funds which cater differently for the ways in which members may choose to take their benefits or, perhaps, by considering structured products or other new solutions remains to be seen.

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